

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0606RST Sales and Use Tax For Years 1994-1997

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ISSUES

I. Sales Tax – Imposition

Authority : Ind. Code § 6-8.1-5-1(b);
Indiana Department of Revenue, Form AD-9, Explanation of
Adjustments (Aug. 7, 1998).

The taxpayer protests the amount of sales tax assessed in the audit report.

II. Use Tax – Sample Projection Methodology

Authority: Ind. Code § 6-2.5-5-3;
Ind. Admin. Code tit. 45, r. 2.2-5-8;
Ind. Admin. Code tit. 45, r. 2.2-5-12;
Indiana Dept. of Revenue v. Cave Stone, Inc., 457 N.E.2d 520
(Ind. 1983);
Indiana Dept. of State Revenue v. RCA Corporation, 310 N.E.2d
96 (Ind. App. 1974).

The taxpayer protests the sample projection methodology used in the audit report.

III. Use Tax – Imposition

Authority: Ind. Code § 6-2.5-2-1;
Ind. Code § 6-2.5-3-2;
Ind. Code § 6-2.5-5-3;
Ind. Admin. Code tit. 45, r. 2.2-3-12;
Ind. Admin. Code tit. 45, r. 2.2-5-8;
Indiana Dept. of Revenue v. Cave Stone, Inc., 457 N.E.2d 520
(Ind. 1983).

The taxpayer protests the imposition of use tax on various specific purchases.

IV. Tax Administration – Penalty

Authority: Ind. Code § 6-8.1-10-2.1;
Ind. Admin. Code tit. 45, r. 15-11-2.

The taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

The taxpayer, incorporated in the state of Delaware, is a manufacturer of concrete pipes and pre-stressed concrete products. The taxpayer operates several production facilities in Indiana. The manufacturing process consists of raw materials (aggregate) being loaded onto a conveying system that moves the material to a batch plant where it is mixed to make cement. The cement is poured into molds to form concrete pipes. A packer-head machine vibrates the product to ensure consistency. An off-bearing process is performed by forklifts to move the product from the packer-head machine into the kiln for curing. A steam generator in the kiln area is used to heat and cure the product. A tip-out process is performed where forklifts remove the product from the molds. Forklifts move the product to the yard where the finishing process is performed, imperfections in the product are corrected, and the ends of the pipe are painted for identification purposes.

On August 7, 1998, a sales and use tax audit was completed for the years 1994-1997. Sales tax was assessed for the audit period as a result of a difference between Indiana sales tax remittances and the records of Indiana taxable sales. Use tax was assessed after a sample review of actual purchase invoices for the period April 1, 1997 to December 31, 1997 and a projection of purchases for the entire audit period based on that sample. The taxpayer signed an Agreement for Projecting Audit Results while reserving a right to protest amounts identified in the audit as taxable purchases.

I. Sales Tax – Imposition

DISCUSSION

The taxpayer was assessed sales tax for the audit period. In his report, the auditor explained the reason for the sales tax assessment:

A review of sales invoices, records and tax account reconciliations revealed various differences between Indiana sales tax remittances and the records of Indiana taxable sales. The records indicated various amounts credited for collection of sales tax where reporting and remittances to the state were not in evidence or variances could not be accounted for.

Indiana Department of Revenue, Form AD-9, Explanation of Adjustments, p. 6 (Aug. 7, 1998).

In its protest letter, the taxpayer requested additional time to submit evidence supporting its dispute of sales tax assessed in the audit report. By the hearing date, March 7, 2000, no supporting evidence on the sales tax issue had been submitted and during the hearing, the taxpayer indicated that no such evidence would be submitted. "The notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Ind. Code § 6-8.1-5-1(b). The taxpayer has submitted no evidence to indicate that the assessment was wrong. The taxpayer has not met its statutory burden of proof, therefore the taxpayer's protest of this issue must be denied.

FINDING

The taxpayer's protest is denied.

II. Use Tax – Sample Projection Methodology

DISCUSSION

The taxpayer protests the methodology of the sample projection used by the auditor to arrive at use tax owed for the audit period. The taxpayer signed a Form AD-10A, Agreement for Projecting Audit Results. The execution and acceptance of the agreement does not deprive the taxpayer of any rights to appeal. The sample of purchase invoices reviewed by the auditor covered a nine month period in 1997, as noted in the Statement of Facts, and was used to project purchases subject to use tax for the entire audit period. In its protest letter, the taxpayer argues that "[i]n any projection technique, principles dictate the sample be an exact representation of the population from which the sample was derived." Taxpayer's Protest Letter, page 2 (Oct. 8, 1998). For the sample to be an *exact* representation of the population from which it is derived, it would have to be a review of *all* of the records for the audit period. What the taxpayer suggests would no longer be a sample.

The taxpayer protests the inclusion of six specific items in the use tax sample. These items will be addressed individually.

A. Invoices for Repair Work Performed on Heaters (Plant #5160)

According to the taxpayer, the heaters are used to maintain a certain ambient temperature so that the raw materials may be used in the manufacturing process. The taxpayer states that if the temperature is too low, the raw materials cannot be used. The invoices in question were for repairs done to the heaters. In support of its argument, the taxpayer cites Ind. Admin. Code tit. 45, r. 2.2-5-8(h)(2) which allows a tax exemption for

“replacement parts used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment”

The question is whether or not the heaters qualify as exempt equipment. For the heaters to be exempt equipment, they must have been acquired “for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.” Ind. Code § 6-2.5-5-3(b). The taxpayer states that the heaters are used to control the ambient, that is, surrounding, temperature. This is analogous to the RCA case where RCA claimed an exemption for air conditioning equipment, arguing that the equipment was an essential and integral part of the process of manufacturing television picture tubes. Indiana Dept. of State Revenue v. RCA Corporation, 310 N.E.2d 96, 98 (Ind. App. 1974). In finding that the air conditioning equipment did not meet the “direct use in the direct production, manufacture, ” etc. standard set out in Ind. Code § 6-2.5-5-3, the court stated:

Whatever effect (whether positive or negative) that RCA’s air conditioning or environmental control equipment may have on the tubes RCA manufactures, or on the process of their manufacture, is exerted through the medium or agency of the environment (i.e. the air). The very name of the equipment, whether “air conditioning” or “environmental control”, signifies that its immediate effect is on the surroundings in which the manufacturing process takes place and only remotely, through the intervening agency of those surroundings, on the tubes or on the process by which they are manufactured.

Indiana Dept. of State Revenue v. RCA Corporation, 310 N.E.2d 96, 100 (Ind. App. 1974).

As with the air conditioning equipment in RCA, the taxpayer’s heaters immediate effect is on the surroundings in which the manufacturing takes place, and only remotely on the raw materials. Therefore, the cost of repairs for the heaters is not exempt from use tax because the heaters are not exempt equipment.

B. Fuel Purchases in 1997 (Plant #5160)

The taxpayer agrees that fuel purchases it made in 1997 are taxable but argues that the inclusion of those invoices in the use tax sample projection renders the projection inaccurate. The taxpayer had paid sales tax on fuel purchases during the audit period prior to 1997. Since the sample projection was computed by reviewing invoices from 1997 only, the taxpayer argues that the projection is not an accurate representation for the entire audit period. The taxpayer is sustained on this issue pending audit review.

C. Propane Fuel Purchased for Forklifts (Plant #5182)

The taxpayer was assessed use tax on purchases of propane fuel used to power forklifts. The audit report indicates that the forklifts were used outside of the production process and thus were not exempt equipment, making the fuel used to power them subject to use tax. The taxpayer maintains that the propane fuel purchased is tax exempt because it was used to power two forklifts that were used in the direct production process. The taxpayer cites Ind. Admin. Code tit. 45, r. 2.2-5-12(e) which states:

Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations.

The taxpayer maintains that the two forklifts were used to place cement pipes in kilns to be cured and used to assist in removing the outer molds from the pipes, after the curing process, prior to the pipes undergoing further processing. The fuel would be tax exempt if it was consumed in powering exempt equipment. Equipment is exempt if it is directly used in the direct production or manufacture of tangible personal property. Ind. Code § 6-2.5-5-3(b).

Equipment that transports work in progress has been found to meet the requirements of Ind. Code § 6-2.5-5-3. Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (Ind. 1983). In that case, the Indiana Supreme Court found that the equipment used to transport stone from the company's quarry to the crusher and then to stockpiles was directly used in the direct production of tangible personal property. The stone was work in process and the equipment used to move it was tax exempt. As in the Cave Stone case, the taxpayer is using the forklifts to transport cement pipe that is still being processed. The forklifts are exempt and, thus, the fuel to power them is exempt. The taxpayer is sustained on this issue pending audit review.

D. Lease of Communications System (Plants #5142 & 5144)

The taxpayer concedes the use tax assessment on its lease of a communications system in 1997, but argues that this item should be removed from the sample projection because the taxpayer owned its own system prior to 1997. Since the sample projection was computed by reviewing invoices from 1997 only, the taxpayer argues that the projection is not an accurate representation for the entire audit period. The taxpayer is sustained on this issue, pending audit review, as far as the inclusion of the communications system lease in the projection sample. The communications system lease is, however, included in the audit assessment.

E. Invoices for Repair Work Performed on Electric Motors (Plants #5142 & 5144)

The taxpayer argues that repair work performed on electric motors is tax exempt because the motors are components of exempt equipment. Three pieces of equipment were mentioned in the taxpayer's protest letter and described more fully in subsequent information the taxpayer submitted. The palleter is a machine used, prior to the curing process, to form a bell shape on the end of each concrete pipe to allow the pipes to be fitted together. The steam generator produces steam that is used to cure the concrete pipe. The elevator loader is a front-end loader that is used to load raw materials from aggregate piles into the hopper from where the materials are conveyed into the batch plant.

(1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.

(2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax.

Ind. Admin. Code tit. 45, r. 2.2-5-8(h)(1 & 2).

Both the palleter and the steam generator are equipment directly used by the taxpayer in the direct production of tangible personal property, that is, the concrete pipes. To the extent that the invoices for the electric motor repairs represent replacement of the motors themselves or the replacement of worn, broken, inoperative, or missing parts, the price paid by the taxpayer for those parts is tax exempt. To the extent that the invoices represent normal repair and maintenance of the electric motors on these pieces of equipment, the amount paid by the taxpayer for the parts is subject to use tax.

The elevator loader moves raw materials into the hopper. Since the production process does not begin until the materials are in the hopper, the job the elevator loader performs is pre-production activity and, thus, this piece of equipment is subject to use tax. The elevator loader is non-exempt machinery therefore, any repairs done to it are subject to use tax.

F. Lease of a Truck (Plants #5142 & 5144)

The taxpayer concedes the use tax assessment on the lease of a truck in 1997, but argues that this item should be removed from the sample projection because the taxpayer owned all of its trucks prior to 1997. Since the sample projection was computed by reviewing invoices from 1997 only, the taxpayer argues that the projection is not an accurate representation for the entire audit period. The taxpayer is sustained on this issue, pending audit review, as far as the inclusion of the truck lease in the sample projection. The truck lease is, however, included in the audit assessment.

FINDING

The taxpayer is sustained, pending audit review, on items B., C., D., and F. The taxpayer is partially sustained pending audit review, and partially denied on issue E. The taxpayer is denied on issue A.

III. Use Tax – Imposition

DISCUSSION

The taxpayer purchased several pieces of equipment during the audit period. The taxpayer protests the assessment of use tax on these items. The purchases in question will be addressed individually.

A. Purchase of Hyster Challenger Forklift, 1994

The taxpayer was assessed use tax on the full purchase price of a Hyster Challenger forklift. The taxpayer claims that the purchase price was not correctly recorded in the audit report. The copy of the invoice submitted by the taxpayer shows the purchase price to be \$66,582.00, and not \$72,414.00, as shown in the audit report. The taxpayer claims that this forklift is used 40% of the time in production activity and 60% of the time in non-production activities. The production activity consists of removing the cured concrete pipe from the molds prior to finishing work being performed. The non-production activity consists of transporting the finished pipe in the yard and loading the pipe for delivery. The taxpayer claims that it paid tax on 60% of the purchase price and this amount was included in the February 1995 sales tax return.

“Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.” Ind. Code § 6-2.5-5-3(b).

The taxpayer is sustained on the issue of the purchase price of the forklift, as shown on the submitted invoice. The taxpayer is also sustained on the issues of percentage of production/non-production use and payment of tax with the February 1995 sales tax return, pending audit verification.

B. Purchase of Two Mack Tractors, 1994

The taxpayer was assessed use tax on its purchase of two Mack tractors. The taxpayer protests the assessment, claiming that it has already paid the tax. The taxpayer has submitted an invoice showing sales tax was paid on the tractors. The taxpayer is sustained on this issue.

C. Purchase of a Hyster Forklift, 1995

The taxpayer was assessed use tax on the full purchase price of a Hyster forklift. The taxpayer claims that the forklift is used 100% of the time in production activities and is thus tax exempt. The taxpayer states that the forklift is used 30% of the time in off-bearing production, that is, the moving of the concrete pipes from the packer-head machine and into the kiln for curing. The taxpayer states that the forklift is used 70% of the time in the tip-out process, that is, the tipping of the cured pipe out of the molds in order that finishing work may be completed.

The use of the forklift is tax exempt under Ind. Code § 6-2.5-5-3 and Ind. Admin. Code tit. 45, r. 2.2-5-8 as machinery directly used in direct production of personal property. The taxpayer is sustained on this issue subject to audit verification.

D. Purchase of Materials Used to Repair Forklift, 1995

The taxpayer was assessed use tax on the cost of repair for a forklift. The taxpayer protests the assessment, claiming that it has already paid the tax. The taxpayer has submitted an invoice showing that sales tax was paid on the repair parts. The invoice separately states the price for the repair parts and the price for the labor. The taxpayer is sustained on this issue.

E. Purchase of Case Loader, 1995

The taxpayer was assessed use tax on the purchase price of a Case loader. The taxpayer protests the assessment because it claims that the tax was already paid. The taxpayer also claims that the loader is used 100% of the time in production activities and is, therefore, tax exempt. The taxpayer cites Ind. Admin. Code tit. 45, r. 2.2-5-8. The taxpayer has submitted an invoice showing that sales tax was paid on the loader. The taxpayer argues that the loader is used 100% of the time to load raw materials onto the batch plant conveying system and that this constitutes the first stage in the production process, making the purchase of the Case loader tax exempt.

The State of Indiana imposes a sales tax on retail transactions in Indiana. Ind. Code § 6-2.5-2-1. In addition, a use tax is imposed on the storage, use, or consumption of tangible personal property in the state. Ind. Code § 6-2.5-3-2. There are, however, exemptions to these taxes. Ind. Code § 6-2.5-5-3(b), known as the equipment exemption, states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Additionally, Ind. Admin. Code tit. 45, r. 2.2-5-8(c) states:

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser

in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

In deciding that the taxpayer was entitled to the equipment exemption, the Indiana Supreme Court in the Cave Stone case found that the equipment used to transport stone from the company's quarry to the crusher and then to stockpiles was directly used in the direct production of tangible personal property. Indiana Dept. of Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (Ind. 1983).

The instant case is distinguishable from the situation described in Cave Stone. In Cave Stone, the taxpayer began the production process by blasting and removing stone from its own quarry. The equipment used to move the stone was transporting unfinished work in process, and thus, exempt. Here, the loading of raw materials onto a conveying system is not part of the production process. The production process begins in the batch plant itself. The loader is being used to introduce raw materials into the beginning of the production process and is not being used to transport unfinished work in process. The loader, as used by the taxpayer in this case, is engaged in pre-production activities and is not a piece of equipment that qualifies for the tax exemption. The taxpayer is sustained on the issue of whether it has already paid the sales tax on the Case loader but denied on the issue of taxability of the equipment.

F. Construction of a New Building, 1996

The taxpayer was assessed use tax on the construction of a new shop building. The taxpayer protests the assessment, claiming that the contract for the construction stated the materials and labor as one price. The taxpayer cites Ind. Admin. Code tit. 45, r. 2.2-3-12 and argues that the contractor is liable for the tax, not the taxpayer. The taxpayer has submitted an invoice showing that the cost of construction of the building was stated as a single price, including materials and labor.

"A person making a contract for the improvement to real estate whereby the material becoming a part of the improvement and the labor are quoted as one price is liable for the payment of sales tax on the purchase price of all material so used." Ind. Admin. Code tit. 45, r. 2.2-3-12(d). The invoice submitted by the taxpayer shows a single price, including materials and labor, for the construction of the new shop building. The taxpayer, therefore, is not liable for the tax and is sustained on this issue.

G. Purchase of a Hyster Forklift, 1997

The taxpayer was assessed use tax on the purchase of a Hyster forklift. The taxpayer protests the assessment, claiming that it has already paid the tax. The taxpayer has

submitted an invoice showing that sales tax was paid on the purchase. The taxpayer is sustained on this issue.

FINDING

The taxpayer is sustained on issues B., C., D., F., and G. The taxpayer is partially sustained, and partially sustained pending audit verification on issue A. The taxpayer is partially sustained and partially denied on issue E.

IV. Tax Administration: Penalty.

DISCUSSION

The taxpayer protests the imposition of a ten percent (10%) negligence penalty for its failure to remit sales and use tax. If a taxpayer incurs a tax deficiency that, upon examination by the Department, is due to negligence, a ten percent (10%) penalty is imposed. Ind. Code § 6-8.1-10-2.1(a & b).

Negligence on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Ind. Admin. Code tit. 45, r. 15-11-2(b).

The negligence penalty shall be waived if the taxpayer can show that the failure to remit the tax owed was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1(d). The taxpayer has presented no evidence to show that its failure to remit the sales and use taxes it owed was due to reasonable cause. The taxpayer had a use tax accrual procedure in place but dropped it in 1996. Known differences between Indiana sales tax remittances and Indiana taxable sales were unresolved by the taxpayer and significant amounts of use tax were not remitted on several major purchases. As a result, the negligence penalty was properly imposed.

FINDING

The taxpayer's protest is denied.